

The human capital role of independent scholarship in auditing

William Kinney
McCombs School of Business
University of Texas at Austin

My comments today are based on my experiences as an auditing educator for almost forty years, as a non-practicing member of the ASB and the IAASB, and as a member of advisory panels for the GAO, FASB, and PCAOB. I'll discuss the decline of independent audit scholarship that, I believe, underlies three of your recommendations on human capital.

Human capital is the core of any profession and independent professional scholarship (i.e., education and research) is an essential element of a profession's human capital. Professional scholarship typically involves study of current and alternative professional practices. As an example from medical school, surgery students are taught how practicing surgeons typically approach a surgical procedure and why they do so. Similarly, medical school-based researchers charged with expanding knowledge of surgery analyze and test current surgical practices against promising alternatives. In turn, courts and legislatures often use cumulative knowledge about the best surgical practices to evaluate and regulate surgeons' performance in the public interest.

For several decades prior to about 1990, the same knowledge transfer and creation process described the public company auditing profession. Large audit firms shared audit practices with professors through audit manuals, training sessions, journal articles, and audit methods conferences. They often provided access to firm data such as audit adjustments, fees, and audit labor hours, as well as access to personnel for participation in research studies.

The contact improved classroom instruction for new entrants to the auditing profession and it also facilitated independent research about the effectiveness and efficiency of alternative auditing practices. In turn, the research brought insights and solutions to auditing practice problems using concepts from psychology, judgment decision making, economics, political science, governance, statistics, game theory, and computer science.

Practitioner/professor contact declined after about 1990. Some observers believe the decline was due to audit firms' increasing concerns about litigation. Others attribute it to cost and perceived competitive disadvantage, while some say it reflected de-emphasis of auditing in the mid-1990s. Whatever the cause, the decline accelerated after SOX and formation of the PCAOB. The PCAOB itself has not been a substantial vehicle for systematic knowledge transfer and, to my knowledge, it does not employ audit-trained researchers.

Today, we've benefited from research on the *output* of auditing practice (that is, research *about* audits). We know how stock prices are related to financial information, to *restatements* of financial information and whether management judgment or fraud is present, and whether analysts' forecasts are met. In fact, in leading scholarly accounting journals today, more studies are published about analysts' earnings forecast behaviors than about how auditors *audit* earnings! Also, we know that audit fees of 2,600 accelerated filers audited by Big Four auditors from 2003 through 2006 increased by 93% and that there are substantial benefits from audits – more than half a dozen scholarly studies suggest that financial statement audits lower the cost of capital for U.S. public companies by 25 to 70 basis points. These research results *about* audits are available

because archival data are available – but these studies are largely devoid of any knowledge or consideration of audit process!

In contrast to research *about* audits, since about 1990, research *in* auditing (or audit process research) has largely ceased to exist due to the lack of practitioner/professor contact. As examples, outside the Big Four firms, whether and how new statistical applications are built into complex audit software is largely unknown and there are no comprehensive published studies of U.S. public company audit effectiveness or efficiency, although the CAQ or PCAOB may evaluate such matters privately. We do know that from 2003 to 2006, Big Four accounting and auditing services staffs increased by more than 44% while partners increased by less than 4%, implying that most post-SOX employment growth has been at *lower-expertise* positions. But, these data include accounting and private client services – we know little about growth at various audit expertise levels for public company audits.

The lack of recent behavioral research in audit process is of even greater concern. Behavioral audit process research conducted largely before 2000 shows that auditors exhibit at least a dozen known and substantial judgment biases when making accounting and auditing judgments. These biases are strong enough to appear in *laboratory settings* without real world pressures and without incentives to please others.

Judgment biases are also almost certainly exhibited by management in making judgments about accounting estimates and fair values under U.S. GAAP and especially under IFRS. Audit staff members must then make judgments *about* judgments of management and, in the future, may be cautioned to “respect management’s reasoned judgments” as suggested by the SEC’s CIFIr panel. The audit process may shift from

“given the rules, *is* management’s number right?” to “given the principles and alternative valuation models, *could* management’s number be right?” Audited results will increasingly reflect human judgment biases of management and auditors as well as their comparative expertise and incentives to act in their own interests.

How much will these known and inherent biases affect audited results? We don’t know. Can standards setters and regulators write and enforce adequate standards for forming and evaluating judgments and especially judgments *about* judgments? Again, we don’t know, but now seems a bad time to have effectively precluded behavioral research *in* auditing – research that might help avoid negative consequences for the profession, investors, and the public at large.

The public needs to know if audited financial statements are reliable, if ICFR audit benefits are worth their cost, and if there are cheaper or more effective ways to do audits. The public also needs to have confidence in the oversight process.* The PCAOB may know from its inspections whether standards have been followed, but are PCAOB Interim Standards that are being applied adequate today? As with surgery, independent scholarly research *in* current practice is needed to find out.

Simply put, today’s audit process is largely unknown and is treated as a “black box” both on and off campus. The “disconnect” harms all parties. It deprives *auditing students* of relevant audit education while in college, it deprives promising *PhD students* of the opportunity to succeed as professors through meaningful teaching and research in auditing, and it deprives *practitioners* of conceptual knowledge freely available at

* For example, most of my own research in this century has tested statements of SEC officials and professional guidance including SAS No. 89, SAB No. 99, and SOX sections 302 and 404. Most of this research used publicly available archival data, but two studies used non-public sources with prior agreements from data providers to allow publication of findings whatever the research outcome.

universities that might facilitate new and innovative solutions to emerging practice issues. Finally, it deprives *practitioners, investors, and the general public* of independent research that evaluates public company auditing.

Time doesn't allow consideration of the full array of possible remedies to the practitioner/professor disconnect, but I'll comment on three posed in the Committee's report.

First, I fully support sabbaticals for professors to participate in meaningful practice activities (Recommendation 3(b)). I've benefited greatly from an August 2007 – February 2008 assignment as an academic fellow in the Professional Practice Group of OCA at the SEC. I now better understand the interaction of regulatory process, standards setting, and practice and my students have already benefited through more relevant classes. My assignment at the SEC was part-time and only seven months due to my school's shortage of auditing instructors. For many professors, flexibility in timing and employment terms may be essential to designing effective practice sabbaticals.

Second, legislation encouraging access to data (Recommendation 3(c)) may seem extreme, but there is public as well as private need for data to support independent research about public company auditors' performance in fulfilling their statutorily-mandated service.

Third, Professor Carcello's idea of professional schools for public company auditing (Recommendation 5) deserves consideration as a possible mechanism to build and maintain human capital through independent scholarship in public company audits.

I hope that these comments will be useful to the Committee and thanks for your attention and consideration.